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## FASB approves new transition method and lessor practical expedient for leases standard

March 29, 2018

KPMG reports that the FASB approved amendments to create an additional transition method and a lessor practical expedient for separating lease and non-lease components.

### Applicability

- **Optional transition relief.** Companies within the scope of the leases standard (ASC 842).
- **Lessor separation of lease and non-lease components.** Lessors with contracts that contain lease and non-lease components (e.g. common area and other forms of maintenance or operational services).
- **Sales and other similar taxes.** Lessors that enter into leases that give rise to sales and other similar taxes.
- **Lessor costs paid by lessee.** Lessors with leases for which the lessee pays lessor costs (e.g. lessor-owned taxes or insurance that primarily benefits the lessor) directly to third parties.

### Key facts and impacts

The Board decided to finalize the proposed amendment to ASC 842 that would give companies the option to not adjust their comparative period financial information (e.g. years ended December 31, 2017 and 2018 for a calendar year-end public company) for the effects of ASC 842 or make the new required lease disclosures for periods before the effective date.

Under this alternative, the effective date of ASC 842 would be the date of initial application on transition.

The Board approved a practical expedient permitting lessors to make an accounting policy election by class of underlying asset to not separate non-lease components of a contract from the lease component to which they relate when specific criteria are met. The ASU will reflect significant changes from the original proposal.<sup>1</sup>

The Board also decided to undertake an additional project to amend ASC 842 that would:

- add a lessor practical expedient similar to the one in the revenue standard (ASC 606) that permits companies to present sales and other similar taxes that arise from a specific revenue-generating transaction on a net basis; and<sup>2</sup>
- stipulate a lessor should not estimate lessor costs paid by the lessee directly to a third party when the lessor does not know and cannot determine the amount of those costs. In those cases, neither the cost nor the lessee payment should be reflected in the lessor's income statement (i.e. they should be presented on a net basis).

<sup>1</sup> Proposed ASU, Leases (Topic 842): [Targeted Improvements](#), January 5, 2018

<sup>2</sup> ASC 606, Revenue from Contracts with Customers, and ASC 606-10-32-2A

## Optional transition relief

The leases standard currently requires a modified retrospective transition approach, with application (including disclosures) in all comparative periods presented. Therefore, for a public company with a January 1, 2019 effective date, the date of initial application would be January 1, 2017.<sup>3</sup> This would be the date at which it first recognizes new right-of-use assets and lease liabilities for existing operating leases and recognizes its transition adjustments.

The Board approved an amendment to ASC 842 during its March 7, 2018 meeting. This amendment permits a company to use its

effective date as the date of initial application. Therefore, a company electing this option will:

- not restate comparative period financial information for the effects of ASC 842;
- not make the new required lease disclosures in comparative periods beginning before the effective date; and
- recognize its cumulative effect transition adjustment (e.g. for the effect of unamortized initial direct costs that are required to be written-off at transition) as of the effective date (January 1, 2019 for a calendar year-end public company).

### KPMG observation

The Board clarified on March 7 that companies will continue to present their ASC 840 disclosures for the comparative periods in the financial statements when they adopt ASC 842 if they elect the new transition option. For example, even though under ASC 840 companies do not generally include their prior year-end operating and capital lease maturity tables in their interim and annual financial statements for the current year, companies electing this new, non-comparative transition option will be required to include them in each set of interim and annual financial statements issued during the adoption year.

Companies should consider this requirement when preparing their ASC 840 lease disclosures for remaining periods before the effective date. Not only will financial statement users focus more attention on these disclosures to obtain comparative financial information, but the ASC 840 disclosures will be included with the new ASC 842 disclosures in each set of financial statements issued during the year of adoption. This may raise questions from financial statement users or regulators if there are significant discrepancies between the comparative ASC 840 information and the new ASC 842 information that cannot be explained by changes in the company's leasing activity.

## Lessor separation of lease and non-lease components

The leases standard currently requires a lessor to separate lease components from non-lease components of a contract in all cases.<sup>4</sup> A lessor then allocates the consideration in the contract to each separate lease and non-lease component based on the transaction price allocation guidance in ASC 606.<sup>5</sup>

Even when separation does not affect the amount or timing of total (lease and non-lease) revenue recognition, a lessor must separate lease and non-lease components and allocate consideration among those components to meet

the separate disclosure requirements in ASC 842 and ASC 606. Furthermore, public companies have to consider the SEC presentation requirements to separately present rental income from service and tangible product revenues.<sup>6</sup>

Many lessors told the FASB that the requirement to separately account for lease and non-lease components when the effect relates only to presentation and disclosure – i.e. the separation of the components has no effect on the amount or timing of revenue recognition – is costly, complex and provides minimal, if any, benefit to financial statement users.

<sup>3</sup> KPMG's Handbook, Leases, section 13.2

<sup>4</sup> KPMG's Handbook, Leases, section 4.4

<sup>5</sup> KPMG's Handbook, Revenue Recognition, chapter 6

<sup>6</sup> SEC Regulation S-X, Rule 5-03(b) Income statements

At the March 28, 2018 FASB meeting, the Board approved a practical expedient to allow a lessor to combine lease and non-lease components when two specific criteria are met. Those criteria are:

- the timing and pattern of transfer<sup>7</sup> to the lessee of the lease component and the non-lease component(s) associated with that lease component are the same; and
- the lease component, if accounted for separately, would be classified as an operating lease.

If a contract includes multiple non-lease components, one or more that meet the timing and pattern of transfer criterion and one or more that do not, the lessor combines those components that meet the criterion with the lease component and does not combine the non-lease components that do not.

Additionally, the Board decided that if the non-lease component(s) is (are) the predominant component(s) of the combined component, the

lessor should account for the combined component under ASC 606 instead of the leases guidance in ASC 842. All other combined components would be accounted for under ASC 842 as a single lease component classified as an operating lease. This would include when the lease component and non-lease component(s) are equally significant to the contract.

This practical expedient would be an accounting policy, elected by class of underlying asset. A lessor electing this expedient would disclose the following:

- its election of the practical expedient;
- the classes of underlying assets to which it applied the expedient; and
- the nature of non-lease components that it is combining with lease components (or vice versa if the combined component is predominantly not a lease).

## KPMG observation

### Changes from the proposed ASU

The lessor separation and allocation practical expedient was initially proposed with real estate lessors in mind. Those companies told the Board that it was difficult to separate lease and common area maintenance (CAM) components that they do not sell separately. However, the practical expedient will likely provide significant relief to many lessors in multiple industries.

The Board's decision significantly expands the relief provided by the practical expedient from its earlier proposal because Board members ultimately decided not to require that the combined component be:

- classified as an operating lease to qualify for the practical expedient; and

— accounted for as a single lease component *in all cases*, including when the predominant element(s) of the combined component are non-lease services.

In addition, the Board's decision to determine eligibility for the practical expedient based on the lease and non-lease components having the same 'pattern of transfer', rather than the proposed 'pattern of revenue recognition', will further expand the expedient's availability compared to the proposal. For example, the expedient will likely now apply to many 'net' real estate leases that would not have qualified for the expedient under the proposal.

The Board's decision also will more closely align the practical expedient with the guidance in the revenue standard compared with what was proposed.<sup>8</sup>

<sup>7</sup> The proposed ASU referred to 'pattern of revenue recognition', which would have resulted in unintended consequences highlighted by many respondents in their comment letters.

<sup>8</sup> Paragraph BC116 in ASU 2014-09, *Revenue From Contracts with Customers* (Topic 606), permits companies to combine two or more distinct goods or services if they are concurrently delivered or have the same pattern of transfer to the customer.

## KPMG observation

### Pattern of transfer criterion

When assessing this criterion, a lessor will separately assess the pattern of transfer of the lease and the non-lease component (e.g. under the revenue standard).

The operating lease component will nearly always have a time-based – i.e. straight-line – pattern of transfer to the customer. Therefore, to qualify for the practical expedient:

- the non-lease component must meet one of the criteria in the revenue standard to be satisfied over time;<sup>9</sup> *and*
- the pattern of transfer to the lessee of the non-lease component must, in general, be time-based – i.e. the measure of progress to be applied to the component must generally be a time elapsed input or output measure.<sup>10</sup>

### Classification of the lease component separately

The Board and staff observed at the March 28 meeting that determining the timing and pattern of transfer of a lease component requires consideration of the classification of the lease. In addition, the second criterion that must be met to qualify for the practical expedient is that the lease component, if evaluated separately, must be classified as an operating lease. Some stakeholders expressed concern that applying the ‘lease payments’ classification test would appear to require the lessor to allocate the consideration in the contract for the combined component to the lease and non-lease elements only to then be able to apply the practical expedient. This would negate the benefits of the expedient.

The Board discussion suggests that the ASU will permit lessors to take a ‘reasonable approach’, similar to applying a portfolio approach<sup>11</sup>, that would not require a quantitative allocation to the lease and non-lease components.

Furthermore, we believe that in many cases, lessors will be able to prove the operating classification of the lease by performing the lease payments test using the combined lease and non-lease payments. For example, this will occur with many real estate leases where the non-lease CAM component would be relatively insignificant compared with the lease. If the *combined* payments pass the lease payments test, then any possible allocation to the lease payments also would.

### Predominance element

We believe that in many cases, determining whether to account for the combined component as a single lease component or as a single non-lease component (e.g. in the scope of the revenue standard) will be simple. For example, in most real estate lease scenarios we think it will be clear that the lease is the predominant element of the combined component. Similarly, in many other arrangements, such as those for consumer high-speed internet or cable/satellite television services, it will be clear that any leases of customer-premise equipment are merely a minor element of the combined component.

There may be other cases that require more judgment to make this determination. However, given the similarities between the revenue and lessor accounting guidance and the robust disclosure requirements of each, we believe companies and practitioners will be able to reach reasoned conclusions. The FASB vice chairman expressed his view that in “close call” situations, he hopes reasonable judgments will be respected. In such situations, we believe it may be relevant to consider which standard’s guidance and disclosures will provide more useful information to the company’s financial statement users.

### Accounting for existing leases with lease and non-lease components on adoption

In its discussions the Board acknowledged that some lessors may have separated lease and non-lease or executory cost elements (e.g. for tenant

reimbursements of CAM) on their income statement under ASC 840 for leases to which they will apply the new lessor practical expedient under ASC 842. The Board decided that for those existing leases (i.e. those that commence before the effective date of ASC 842), lessors should

<sup>9</sup> ASC 606-10-25-27

<sup>10</sup> ASC 606-10-25-31– 25-37

<sup>11</sup> Paragraph BC120 in ASU 2016-02, *Leases*

apply their ASC 842 accounting policy from the effective date (if they elect the new non-comparative transition option) or from the beginning of the earliest comparative period presented (if they do not elect the new non-comparative transition option). That is, lessors should combine lease and non-lease elements arising from an existing lease if they would also

do so if the lease were a new lease that commenced on or after the effective date.

A lessor electing the new non-comparative transition option would not be required to recast its income statement presentation for periods before the effective date of ASC 842.

### KPMG observation

#### Possible complexity in some scenarios

It is possible that the Board's requirement with respect to existing leases could create some complexity for a lessor if the lessor's lease contracts contain multiple non-lease components and one or more of those non-lease components do not qualify for combination with the lease component (e.g. a service that does not have a time-based pattern of transfer to the lessee). In that case, the lessor may have to undertake an allocation exercise between non-

lease components to determine the amount that should be combined with the lease revenue and the portion that should remain segregated.

#### Comparative periods under new transition option

While a lessor electing the new non-comparative transition option would not be required to recast its income statement presentation for periods before the effective date, the Board did not address whether a company would be prohibited from doing so if it elected the new transition method.

### Sales and other similar taxes

ASC 606 permits a company to elect to exclude all sales and other similar taxes from the transaction price for its contracts with customers. Similar taxes include use, value added and some excise taxes that are imposed on and concurrent with a specific revenue-producing transaction and collected by the company from a customer. This election permits the company to present all collections from customers for these taxes on a net basis, rather than having to assess whether the company is an agent or a principal in each taxing jurisdiction. In contrast, if it does not make this election, it needs to evaluate whether it is the principal or an agent in each taxing jurisdiction.

At the March 28 Board meeting, the Board decided to propose an amendment to ASC 842 that would create a similar practical expedient for lessors. This would mean that, as an accounting policy election applied to all of the lessor's leases, a lessor could present all collections from lessees of sales and other similar taxes on a net basis, rather than assessing for each tax and/or taxing jurisdiction whether the tax is a 'lessor cost' because the lessor is the primary obligor for the tax.

### Lessor costs paid directly by the lessee

ASC 842 states that a lessee's payment of a lessor's costs (whether paid to the lessor or directly to a third party) is not a component of a lease contract. A lessor should recognize lessee payments of lessor costs as additional lease revenue, separate from the cost, regardless of whether the lessee makes the payments to the lessor or directly to a third party (e.g. a taxing authority). Examples of lessor costs include taxes for which the lessor is the primary obligor or insurance covering the underlying asset for which the lessor is the primary beneficiary.

Some lessors asked the FASB about how they should treat lessee payments of lessor costs when the lessee pays those amounts to a third-party directly and the lessor does not know, and will not know (e.g. there is no reporting mechanism under the lease contract), the amount paid by the lessee. This may arise, for example, with insurance that covers the underlying asset. The lease contract may require the lessee to obtain insurance that covers the underlying asset for which the lessor is the primary beneficiary, but the lessee may not be required to provide policy premium information. Because the premium may be affected by a number of lessee-specific factors (e.g. the lessee's credit rating,

claim history and/or discounts stemming from other policies the lessee has with the insurer), or because the underlying asset may be covered under an umbrella insurance policy, the policy premium may not be known or determinable by the lessor.

At the March 28 Board meeting, the Board decided to propose an amendment to ASC 842 that would clarify that, in cases such as the

example in the preceding paragraph, the lessor should not estimate the amount of the lessor costs paid by the lessee. Instead, the lessor should recognize the costs and lessee payments net in the income statement, which would negate the need to estimate those costs. The Board considered and rejected a proposal that lessors should also be permitted to present lessor costs and reimbursements by the lessee *to the lessor* of such costs on a net basis.

### KPMG observation

#### Sales and other similar taxes

The basis for the Board's decision on sales and other similar taxes appeared to be, as expressed in ASU 2016-02, that leasing is fundamentally a revenue-generating activity for lessors.

Therefore, the Board members believe it is appropriate for lessors to have a similar practical expedient as ASC 606 for the same types of taxes.

The Board's decision applies only to those taxes that are in the scope of the ASC 606 sales and other similar taxes practical expedient. This means that taxes are not eligible for this practical expedient unless they both arise from a specific leasing transaction and are collected by the lessor from the lessee. Ineligible taxes must be assessed by the lessor in each applicable taxing jurisdiction.

#### Lessor costs paid directly by the lessee

The Board's decision on this issue considered the discussion on *Estimating Gross Revenue as a Principal* in the basis for conclusions to ASU 2016-08.<sup>12</sup> In that discussion, the Board expressed its view that the transaction price in a revenue contract does not include variable consideration for which the uncertainty will never be resolved.

An example under ASC 606 would be a payment from a customer to an agent of the company (i.e. an intermediary) for which the agent will never report the amount of the customer's payment to the company.

The relevant leases analogy is to lessee payments of lessor costs, made directly to third parties, where the lessee is effectively an agent for those payments, and is not required to report the amount it pays to the lessor. In that case, if the lessor does not, and will not, know the actual amount paid, and the amount is not otherwise determinable (e.g. from available tax records), the lessor should recognize the costs and the lessee's payments on a net basis in the income statement. Otherwise, lessee payments of lessor costs, whether paid to the lessor or directly to a third party, should be recognized gross in the lessor's income statement.<sup>13</sup>

The Board briefly discussed the level of effort a lessor should be expected to expend in trying to determine the amount paid by the lessee if it is not directly reported to the lessor. The Board did not make any decisions, so this is likely to remain unclear until a proposed ASU is released. However, during the Board discussion, an FASB staff member indicated that generally it would be expected that a lessor could obtain relevant tax information about taxes to which it is the primary obligor.

### Effective dates and transition

The effective date of the final ASU on transition and the new lessor practical expedient will coincide with the effective date of the new leases standard for companies that have not early

adopted. For companies that have early adopted ASC 842, the transition portion of the ASU will be effective on issuance. A lessor that has early adopted the leases standard may adopt the new lessor practical expedient at either the:

<sup>12</sup> Paragraphs BC37 and BC38 in ASU 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)

<sup>13</sup> KPMG's Handbook, Leases, Question 7.3.40

- beginning of the first financial reporting period that begins after issuance of the ASU; or
- original mandatory effective date of ASC 842 for the company.

## Next steps

The Board will issue an ASU codifying the new transition option and the lessor practical expedient as well as a technical corrections ASU.<sup>14</sup> The expected timing for these ASUs is not yet known. However, based on discussions with

the FASB staff, we do not expect that the ASU on transition and the new lessor practical expedient will be issued before the 10-Q filing deadline for calendar year-end public companies, which could affect some companies' plans to early adopt the new leases standard.

The Board instructed the FASB staff to bring back its proposed amendments on sales and other similar taxes and lessor costs paid directly by the lessee to a future meeting for discussion by the Board before exposing in a proposed ASU.

<sup>14</sup> KPMG's Defining Issues, [FASB approves technical corrections to new leases guidance \(ASC 842\)](#)

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## KPMG's Financial Reporting View

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